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THE HOWE REPORT

The President's Digest

by William B.P. Robson

During the Summer of our Discontent ....

The emergence of China and other big new industrializers into the front ranks of the world economy – hungry for resources and excelling as producers of manufactured goods – has stressed the Canadian economy in recent years. The US housing collapse and credit-market crisis since last summer seem to have pitched us into a crisis. Statistics Canada says GDP contracted in the first quarter. Yet the May inflation report showed a big jump in the consumer price index: adjust for the GST cut in January, and the year-over-year rate is 2.7 percent – very close to the top of the Bank of Canada's 1 to 3 percent target band. We are entering a summer of discontent. No wonder Governor Carney, not to mention finance ministers and governments across the country, are under pressure to do something to ease the pain.

At times like this, policymakers and businesspeople alike need to recall the old supplication: for courage to change what we can, patience to endure what we cannot, and wisdom to know the difference. To sort out the things we can change from those we must endure, it helps to look at one of the neatest summaries I know of the terms-of-trade shift buffeting Canadians: the price of oil versus the price of cars. The figure on page 3 shows how many barrels of oil (priced at point of importation to North America) it has taken to buy the equivalent of a 2008 Ford Fusion for the past 36 years. The swings are stunning: more than 2,000 barrels of oil for a car in the early 1970s; around 300 barrels in the early 1980s; nearly 2,000 again in the late 1990s – and a mere 200 in early 2008.

No wonder oil-producing businesses and regions are booming, and car-producing businesses and regions are struggling. But these ups and downs are not something Mark Carney, federal finance minister Jim Flaherty – or any other policymaker – can change. The oil-price of a car is the same whatever the exchange rate, and whatever the federal budget balance. Some foreign governments may be shorting the oil market with production restraints or consumption subsidies. Others may be force-feeding their manufacturers targeted tax breaks and handouts. No matter how stressed they are, Canadians must not insist on policy responses to every Venezuelan or Vietnamese distortion. This is what the world has served up: our challenge is to

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EVENT ALERTS...

Member Roundtable:

"Report of the Competition Review Panel"
July 17, 2008. Featuring Lynton R. Wilson, Chairman, CAE Inc.

Policy Conference:

"State-Sponsored Investors: Challenges and Responses"
Sept. 26, 2008 at the Metro Toronto Convention Centre.

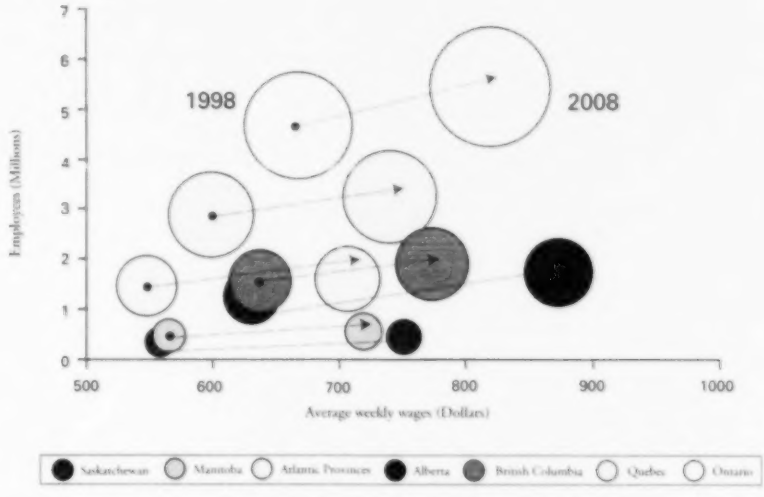
by Finn Poschmann
Director of Research

Where did the jobs grow?

Media stories of happy prosperity in oil-producing provinces, and despair in the rest, miss a longer-term record of strong labour market performance across Canada's regions. The past decade, through spring 2008, is a story of resurgent job growth – and an east-west divide.

What are the key labour market takeaways? Top line – the strength in jobs and wages extends beyond Alberta. Second – Ontario is growing slowly in employment and wages, but it is growing. Third – the East has improved markedly, but has a long way still to go. The implication is that Canada's labour markets are working to steer people to their best opportunities, but that sand remains in the gears.

Who Grew? Jobs and Wages by Province, 1998–2008



Sources: Statistics Canada, CANSIM; author's calculations.

Simple numbers tell an interesting story. Alberta's average weekly wages have grown, in nominal dollars, at 3.3 percent annually for the past decade. Employment has grown even faster, at a 3.6 percent annual compound rate – a net gain of over 500,000 employees. In the figure here, in which bubble sizes are scaled to the number of employees in a province, Alberta's bubble has shifted most, in percentage terms; it has moved upward and to the right, surpassing British Columbia and Ontario in average wages.

Next, in percentage terms, is Saskatchewan, where wages for the past decade have grown at 3.0 percent compounded annually, and employment at 2.0 percent annually. Likewise Manitoba, where wage growth has persistently outpaced employment growth (2.4 and 1.9 percent), but not British Columbia, where wages have grown at 1.9 percent annually and employment at 2.3 percent.

Among this group, Ontario has the largest balloon, perhaps overinflated by government hiring. The province gained three-quarters of a million new jobs over the decade, but delivered a percentage wage growth rate of 2.1 percent per year – and employment growth of only 1.5 percent a year.

And Ontario marks the continental divide – every province to the west had stronger employment growth on the decade, and every province to the east had weaker growth. In 1998, the eastern provinces had double the unemployment rate of the western provinces, a relationship that held true in 2008 as well, even if the rates in all regions were markedly down.

That unemployment is down, and social assistance use is down as well, is good evidence of labour markets at work, as reported in major recent studies in the C.D. Howe Institute's social policy series – from John Richards as well as Ross Finnie and Ian Irvine. Finnie and Irvine, for example, showed that Canada's welfare dependence rate fell by half between 1993 and 2005. What the persistent east-west gap shows, however, is that for all the moving that people are reported to do, the wheels of labour market adjustment grind slowly. Part of the reason, no doubt, is Employment Insurance's continuing regional subsidy to seasonal work – and that is something policy can address, by regularizing EI entrance requirements across the country.

Also needing policy attention – inflation. The wage growth rates reported here often failed to keep pace with inflation, which averaged 2.2 percent on the decade. Had inflation run any quicker, many workers would have felt no wage improvement at all. A hawkish stance on inflation remains justified.

Taken together, the message is that labour markets work, and that social policy has come a long way. Regional disparities persist, which speaks to the need for labour mobility and a growth-oriented economic framework. ■

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pursue the strategies with the best promise for long-term prosperity here at home.

For the Bank of Canada, that means keeping inflation on target. Notwithstanding recent bad economic news, the low and stable inflation Canadians have enjoyed since the early 1990s is a valuable achievement – not least, confidence in the dollar's future purchasing power held long-term interest rates down when the Bank pushed extra money into the system at the height of the ABCP crisis. Add up the prices of oil, cars, and everything else Canadians buy, and it is clear that Canada, like the world, is pressing up against the limits of productive capacity. When the Bank of Canada left the overnight-rate target unchanged in June, it wrong-footed some forecasters. But the decision accorded with the recommendation of the Institute's Monetary Policy Council the week before, and showed the Bank's determination, now the worst of the financial crisis is behind us, to contain inflation as effectively as before.

Price of a Car in Barrels of Oil, 1972–2008

Sources: US Energy Information Administration; Statistics Canada; Ford Canada; author's calculations.

Why is inflationary pressure so strong despite weakening output? That question steers our attention away from things we must endure, and towards things we can change. Canada's productive capacity is stressed partly because resources are moving out of sectors whose products are less in demand and where prices are low, and into sectors whose products are more in demand and where prices are high. Those stresses are unusually large right now – the oil-versus-cars comparison shows that plainly – but if taxes and regulations are slowing the adjustment, the inevitable bottlenecks will be worse and last longer. Productive capacity also seems to be suffering from slowing labour-force growth and decelerating productivity – problems that smarter policies toward work, investment and sectoral regulation would also help.

Finally, and critically, producers of things like cars are getting pinched in the competition for resources within Canada not only by producers of things like oil, but also by growing governments. The OECD released a major study on Canada in June. A central theme of that study was a diagnosis of "Dutch Disease" in Canada. In particular, it noted that tax revenues swollen by the resource boom are inducing the public sector to expand at the expense of manufacturing and other producers of tradable goods and services. The OECD cited the C.D. Howe Institute's work on Canada's lagging tax competitiveness and huge budget overruns over the past decade, documented how governments' share of national consumption, wages and employment has grown since 2000, and warned that these trends are unsustainable. The OECD's job numbers were to 2006, and since then, things are no better: private sector employment is up only 2 percent, while public sector employment is up more than 7 percent.

So we should not let our discontent this summer take our focus off the things that need our attention. As the OECD report also underlines, inflation control, debt reduction and the beginnings of tax relief brought Canada into the current difficult period in much better shape than it would have been in the past, and in much better shape than many other countries. A rough patch is no time to abandon those strategies – in fact, reaffirming our commitment to contain the growth of government and ease the burden of heavy and poorly designed taxes on businesses and families alike would be the best response to the squeeze that has afflicted manufacturing and now seems to have caused the economy to stall.

As the swings in the number of barrels of oil it takes to buy a car highlight, the world regularly challenges Canadians to adapt and innovate in the pursuit of growth and higher living standards. Booms follow busts and busts follow booms. One day, the oil-price of cars will rise again. Our challenge – even in our summer of discontent – is to maintain a course that will ensure our prosperity whatever the world serves up. ■

C.D. Howe Institute Welcomes New Directors

David Dodge, PhD – David Dodge is Chancellor of Queen's University and former Governor of the Bank of Canada, a position in which he served with distinction for the past seven years. Prior to his retirement in January 2008, Dr. Dodge provided wise and steady guidance as the ABCP crisis unfolded.

A native of Toronto, Dr. Dodge received a bachelor's degree (honours) in economics from Queen's University, and a PhD in economics from Princeton. During his academic career, he taught economics at Queen's University, Johns Hopkins University, the University of British Columbia, and Simon Fraser University. His distinguished career in the federal public service included senior positions at the Central Mortgage and Housing Corporation, the Anti-Inflation Board, the Department of Employment and Immigration and the Department of Finance. Dr. Dodge was appointed Deputy Minister of Finance in 1992. In that role, he served as a member of the Bank's Board of Directors until 1997. In 1998, Mr. Dodge was appointed Deputy Minister of Health, a position he held until his appointment as Governor of the Bank of Canada.

Richard Legault, CA, President and Co-Chief Executive Officer, Brookfield Renewable – Richard Legault has served in increasingly senior roles with the Brookfield Group, one of Canada's most successful business enterprises, for almost 20 years. His distinguished career commenced in various senior management positions in the power and forest products sectors within Brookfield's operations. In 1999, Mr. Legault took on the role of Chief Financial Officer for Great Lakes Power Inc. and Senior Vice President, Finance of Brookfield Asset Management, and became Chief Executive Officer (CEO) of the Great Lakes Hydro Income Fund (GLHIF). He was instrumental in creating the Fund and leading the IPO process.

Mr. Legault has a Bachelor of Accounting from the Université du Québec in Hull, and is a member of the Canadian Institute of Chartered Accountants. Today, he continues to hold the CEO position in GLHIF, which is one of the premier power income funds in Canada with a market capitalization of close to $1 billion. Mr. Legault was appointed President and Chief Operating Officer of Brookfield Renewable in 2000 and most recently, became Co-Chief Executive Officer of the Company. He is also a Managing Partner of Brookfield. Mr. Legault has been instrumental in developing and implementing the growth strategy of Brookfield Renewable; under his leadership, the Company grew its asset base from 1,000 MW to almost 4,000 MW over the last seven years and significantly expanded its operating and marketing platform in North and South America.

Alfred G. Wirth, LLD CFP, President and Director – Alf Wirth is one of Canada's most respected business leaders, with an outstanding career in financial services. Currently, he is President of Wirth Associates Inc., investment counsel to high net worth individuals, which he founded in 1991. Mr. Wirth is also a noted philanthropist; his gifts to various causes have included a landmark $1,050,000 gift to the C.D. Howe Institute.

Mr. Wirth previously served as Chief Investment Officer of Sun Life, United Funds, and Crown Life. He his a prolific author of articles on financial services and co-authored the book *Private Placements*, published by *Euromoney*. He has served on the Boards of many organizations such as Accel, American Council of Life Insurance, Enerfund, Genstar Capital, Heart and Stroke Foundation, Helix Investments, Institute for Research on Public Policy, St. Andrews College, Butlers Creek, Toronto Stock Exchange and the Financial Services Commission of Ontario.

As well as advanced financial analysis designations, Mr. Wirth's education includes a BA (Hon. Economics & Political Science) from McGill University and spans various programs at Boston, Dartmouth, Harvard, Oxford, Princeton, Toronto, York, and Vienna Universities. He was awarded an LLD by the University of Alberta in 2005.

Mr. Wirth sits on the Board of Directors of SOS Children's Villages Canada, an orphan child charity. He is also a noted connoisseur of fine wines. His affiliations include President of the International Wine & Food Society, Toronto.